Retirement Income Products

Purpose

The purpose of this paper is to provoke discussion that may lead to amendments to *The Pension Benefits Regulations* with respect to the prescribed methods of payment of pensions on retirement.

Background

The traditional form of pension is the life annuity. Typically with a life annuity, your pension money is paid to a life insurance company. In return, the life insurance company guarantees the payment of a fixed amount of pension for your lifetime.

In 1993, the Government of Saskatchewan introduced the life income fund (LIF) and the locked-in retirement income fund (LRIF) as alternatives to a life annuity. A LIF or an LRIF allow you to continue to manage your pension savings throughout your retirement and to have more flexibility for income and estate planning purposes. However, a LIF and an LRIF are less predictable and more complicated than a life annuity.

The LIF allows you to defer the purchase of a life annuity to the end of the year in which you turn 80 years of age. While in the LIF, your pension money provides an adjustable flow of retirement income within a specified range of minimum or maximum withdrawals. At the same time, you retain control over the investment of the balance of your pension savings and investment earnings continue to grow on a tax-sheltered basis.

The LRIF contains many of the features of the LIF, with the important difference that you are never required to purchase a life annuity. As well, the maximum withdrawal amounts under the LRIF and the LIF are calculated differently.

Details of the LIF and LRIF are provided in a bulletin we have prepared called "Retirement Income Options". You can find a copy of the bulletin on our web site: www.saskjustice.gov.sk.ca (see under "Branches, Boards and Commissions", "Pension Benefits Branch"). You also can obtain a copy from our Branch by phoning (306) 787-7650.

You have the option of opening a LIF or an LRIF if your pension money is in a locked-in retirement account (LIRA), which you may know better as a locked-in RRSP. If you are a pension plan member and you wish to transfer money directly from a pension plan to a LIF or an LRIF at retirement, your plan must permit you to do so. Because a LIF and an LRIF are forms of a pension, you cannot transfer money to a LIF or an LRIF prior to attaining age 55 unless the pension plan from where the money originated provides that your pension may commence at an earlier age.

Definition of Problem

We have received numerous requests from retired persons and their advisors for greater flexibility in retirement income products. Greater flexibility usually means permitting greater withdrawals of income than is currently allowed by regulation, particularly at a young age.

We also have received comments from those responsible for administering and advising on LIFs and LRIFs that the products are complicated and costly to administer. These attributes are exacerbated by the lack of uniformity between jurisdictions on the detailed rules of the LIF or the LRIF.

Desired Characteristics

Requests to change the LIF or the LRIF usually are not accompanied by concrete alternatives. There is much more consensus on the problems than on a solution. That is because there is no "right" answer. Your preference will be predicated on your experiences and values. When you are considering the options presented by this paper you may want to conduct your analysis on the following characteristics.

Self-Determination

A fundamental principle of the current regulations is that a LIF or an LRIF should pay income to a retired person until his or her death. A corollary principle is that a sufficient number of retired persons are not capable of protecting themselves in this regard and, therefore, need the protection of regulations. The result is that LIF and LRIF regulations contain a ceiling on the amount of income you can withdraw in a given year. Protecting the vulnerable is at the core of Saskatchewan Justice. However, this is a level of regulation not experienced in other areas of savings and investment.

In Saskatchewan, only about 35% of the labour force and 47% of paid workers participate in a registered pension plan[1]. A significant number of our residents save for their retirement through registered retirement savings plans (RRSPs). Statistics Canada indicates that, between 1991 and 1997, almost 62% of the taxfilers in Saskatchewan contributed at some point to an RRSP[2].

Subsection 3(2) of *The Pension Benefits Regulations, 1993* provides that *The Pension Benefits Act, 1992* does not apply to registered retirement savings plans. Therefore, the options available to an RRSP holder are those permitted by the *Income Tax Act*, namely, cash withdrawal, purchase of an annuity, or roll over to a registered retirement income fund (RRIF). RRSP holders are not limited by maximum annual withdrawals.

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[1] Statistics Canada – Cat. No. 74-401 – Pension Plans in Canada, 1998

[2] Statistics Canada – Cat. No. 74F0002XPB – Retirement Savings Through RPPs and RRSPs, 1991 - 1997

There also is an interesting contrast with the regulatory approach used to manage the risk associated with investments made by LIF and LRIF holders. You can hold the same types of investments in a LIF or an LRIF as in your RRSP or RRIF. The range of the type of security that qualifies under the *Income Tax Act* (Canada) for an RRSP or a RRIF is broad and includes:

- most types of bonds,
- Canadian stocks listed on a recognized exchanges,
- shares of foreign companies listed on recognized exchanges,
- over-the-counter stock trades on NASDAQ and CDN,
- some limited partnership units,
- units in labour-sponsored venture capital funds,
- shares of small businesses,
- mutual funds,
- mortgages (including your own), and
- call options, warrants and rights issues by companies listed on Canadian exchanges.

The government chooses to regulate trading in, and advising with respect to, securities based on the following principles embodied in *The Securities Act*:

- Only honest and knowledgeable persons should sell securities.
- When securities are first offered to the public, potential investors should have and be able to rely on truthful, complete and understandable selling documents.
- All buyers and sellers should have equal access to information about companies whose securities are trading in the secondary market.
- Persons taking undue advantage of purchasers should be held to account.

The government chooses not to regulate a LIF or an LRIF investor by imposing quantitative limits to achieve an appropriate asset allocation or to avoid inappropriate speculation. As an investor you are not protected from yourself.

Perhaps the time is right to change the regulatory focus from limiting the discretion of retired persons to ensuring that appropriate advice is provided to them in the exercise of their discretion.

Respect for the Pension Contract

Registered pension plans are not mandatory. Therefore, when an employer establishes a pension plan we know that the employer has a single purpose in mind. It has been argued that the restricted payment of a pension through a LIF or an LRIF reflects the contract made between an employer and an employee.

But what is the nature of the promise made under a pension contract? Under a defined benefit pension plan, the contract provides a stream of pension payments. At retirement, a formula, based on factors such as years of service or earnings, determines the amount of your pension income. If you accept that pension regulations should respect the pension contract, then restriction (or the absence of choice for defined benefit pension plan members) is appropriate.

However, a defined contribution or money purchase pension plan promises that a specified amount of money will be contributed on your behalf while you work. The income that is paid in retirement with that money is not specified or guaranteed. Do the LIF and LRIF rules reflect the money purchase plan promise? Would it be sufficient for pension legislation to restrict access to a member's account until he or she reaches retirement, but not to impose limitations in retirement?

The same questions could be asked with respect to a defined benefit plan member who chose to transfer money from his or her pension plan to a locked-in retirement account. In doing so, the pension contract fundamentally changed from a defined benefit promise to a money purchase promise.

Stability and Predictability vs. Adaptability and Flexibility

By stability, we refer to the lack of fluctuation in income from one year to the next. Predictability means that the income payable in old age would be reasonably close to the amount payable at the inception of the pension payments. In conflict with stability and predictability are the characteristics of adaptability and flexibility. Adaptability refers to the opportunity of a retired person to take immediate advantage of better than expected investment performance. Flexibility means allowing a retired person significant access to retirement capital during the first few years of retirement, with a resulting decline in income with age.

A life annuity provides stability and predictability of income. A fixed amount of pension is payable for your lifetime, no matter how poorly the capital markets perform or how long you live. But a life annuity lacks adaptability and flexibility.

The current formula under the LIF also strives to attenuate fluctuations in income, although income will rise and fall in relation to the movement in long term Government of Canada bond yields. A LIF also does a reasonable job of ensuring that your capital remains in tact to provide a level income throughout your retirement. In a sense, holding a LIF is like purchasing a life annuity at the beginning of each year. You have continuing exposure to the risk and reward of the changes in the market value of your assets and long term interest rates, but income is more stable and predictable than under an LRIF.

Performance gains will increase the LIF fund balance and will increase the amount of the pension payment. However, the gains are amortized over the remaining life of the LIF and are not realized immediately. A LIF, therefore, cannot be said to be adaptable. The current LIF also is not flexible. You have no ability to withdraw more than the calculated maximum.

The LRIF was designed with adaptability in mind. Income from an LRIF is based on investment performance. You can withdraw what you earn. But as a result, income from an LRIF can be unstable and unpredictable.

During years when investment performance fails to keep pace with the minimum withdrawal requirements of the *Income Tax Act*, the LRIF holder may have to withdraw capital. However, generally the LRIF maximum withdrawal rule attempts to preserve capital until a relatively old age. Therefore, flexibility is not expressly addressed by the LRIF.

We have not found a variation of a LIF or an LRIF that offers stability and predictability *and* adaptability and flexibility to the degree that has been demanded by retired persons. If "flexibility" is regarded as appropriate public policy, then sufficient flexibility would be difficult to achieve through an altered LIF or LRIF.

Simplicity

The current LIF and LRIF rules are a challenge to administer and to give advice on and are even more difficult to understand for most retired persons. This may be attributable to the relative newness of the products and the low volumes of business. Both of those conditions may disappear with time as the baby boomers approach retirement. It also may reflect an underweighting given to pension benefits regulations in the programs and material used to educate the public and their advisors.

Adding features to the LIF or the LRIF in the name of flexibility would increase the complexity and the cost of the products.

National Uniformity

Nine provincial governments and the federal government currently have legislation governing LIFs. Saskatchewan, Alberta, Manitoba and Ontario (and soon Newfoundland) also have LRIFs. The rules across Canada are substantially similar on principle, but are different in detail. It would be desirable to seek harmony in the rules to encourage the unrestricted movement of workers across Canada and to lower the costs incurred by financial institutions in delivering these products. Those costs ultimately are borne by the consumer.

Options

We would like you to consider the following options. Please do not feel restricted to commenting only on these options. If you do provide an alternative, please explain the rationale for your suggestion. In particular, relate your suggestion to the desired characteristics mentioned above.

Québec LIF

The formula for determining the maximum annual income from a Québec LIF is substantially the same as Saskatchewan's. A Québec LIF is different in the following ways:

- Pension money can be transferred into a LIF at any age.
- You do not have to purchase a life annuity at age 80.
- You can withdraw an additional payment from your LIF. This is called a temporary income. A temporary income cannot exceed 40% of the year's maximum pensionable earnings (YMPE) under the Canada or Québec Pension Plan in the year of the withdrawal. For 2000, the maximum temporary income would be 40% of $37,600 or $15,040.

If you are under age 54, you can request temporary income if your expected income in the next 12 months from other sources does not exceed 40% of the YMPE. If you are between 54 and 65, you can apply for the temporary income regardless of your other income. If you are 65 or over, you cannot receive temporary income. However, if the amount in your LIF at age 65 does not exceed 40% of the YMPE, you can withdraw the entire amount.

The Québec LIF adds an element of flexibility. However, it remains paternalistic and is not simple. Copying the Québec LIF would achieve a small measure of national harmony.

In Saskatchewan, a LIF or an LRIF is available only on retirement. You must be eligible to commence receipt of a pension to transfer money into a LIF or an LRIF. Permitting a transfer to a LIF at any age, as Québec does, would be a significant shift in policy.

Variations on the Québec LIF

We could retain the LIF and the LRIF as forms of pension, but add some elements of the Québec LIF. The requirement to purchase a life annuity at age 80 could be removed from the LIF. The temporary income payment from ages 54 to 65 could be added to both the LIF and the LRIF.

RRIF

A RRIF has been a popular choice for RRSP holders for almost 25 years. A RRIF is similar to an RRSP in that you can hold the same type of investments as your RRSP and investment return remains tax sheltered until it is withdrawn. The main differences between an RRSP and a RRIF are that you cannot make contributions to a RRIF and you must withdraw a minimum amount of income each year based on a formula found in the *Income Tax Act*.

There is no maturity date to a RRIF. You could keep your RRIF for the rest of your life. However, at any time you could withdraw any amount of capital you want, including the total amount of your fund. Withdrawals are taxed at your marginal tax rate.

Permitting pension money to flow to a RRIF would represent a fundamental change in policy. In effect, pension money would become unlocked in retirement. Without a doubt, we would find cases of retired persons who exhaust their pension capital early in retirement. And while we might expect the desire to spend to be greater at younger ages, it is not clear that in the decades ahead our need to spend will diminish with age. Having private savings in our old age might make a considerable difference in our quality of life and on the pressure on the public purse.

The public policy risk associated with unlocking would be mitigated by the following:

- As mentioned, in Saskatchewan, a LIF or an LRIF is regarded as a form of pension. A RRIF would receive the same treatment. A RRIF would be available only on retirement. Pension money would remain locked in until then. It is axiomatic that those faced with the prospect of retirement are going to place a higher priority on using pension savings to provide pension income than younger persons.

- There are two ways pension money can move to a LIF or an LRIF. The same would apply to a RRIF. First, a pension plan could contain a provision permitting a direct transfer on retirement as an optional form of pension. More commonly, money finds its way to a LIF or an LRIF from a LIRA.

  Pension money may be transferred from a plan to a LIRA on termination of employment. You have the right to transfer money to a LIRA if you are vested and you terminate employment before being eligible to receive a pension. A pension plan may provide that a member can transfer money to a LIRA on termination of employment while in the retirement window, but is not obligated to do so.

  Therefore, after you reach early retirement age, a plan could provide that you must receive a pension from the plan or a life annuity from an insurance company. The plan would not be required to permit a transfer to a RRIF. The plan could maintain a level of protection for plan members.

Other Issues

Life Annuity

The life annuity will always have a place in our retirement plans. Nothing in this paper should be construed as diminishing the importance of this product. It will continue to be a prescribed method of payment of pension.

Protection of Spouses

If you have a spouse, pension legislation requires that your pension be offered in a "joint and survivor" form, which provides for the payment to your surviving spouse of a lifetime pension on your death of at least 60% of the pension that was being paid to you. The amount of the pension payable to you at retirement may be reduced to ensure that continuing payments can be made throughout your lifetime and also your spouse's lifetime.

You may receive a pension that does not offer this survivor benefit only if your spouse sig · the waiver prescribed by legislation prior to the commencement of your pension. Therefore, your spouse must sign a waiver prior to the purchase of a single life annuity, a LIF or an LRIF. That also would continue to be the case if the government decided to pursue the RRIF option.

Comments

Comments should be submitted by **September 30, 2000**.

You can e-mail your comments to Dave Wild, Superintendent of Pensions at dwild@justice.gov.sk.ca

Alternatively, comments can be mailed or faxed to:

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